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RAILWAY SPECULATION

SUMMARY

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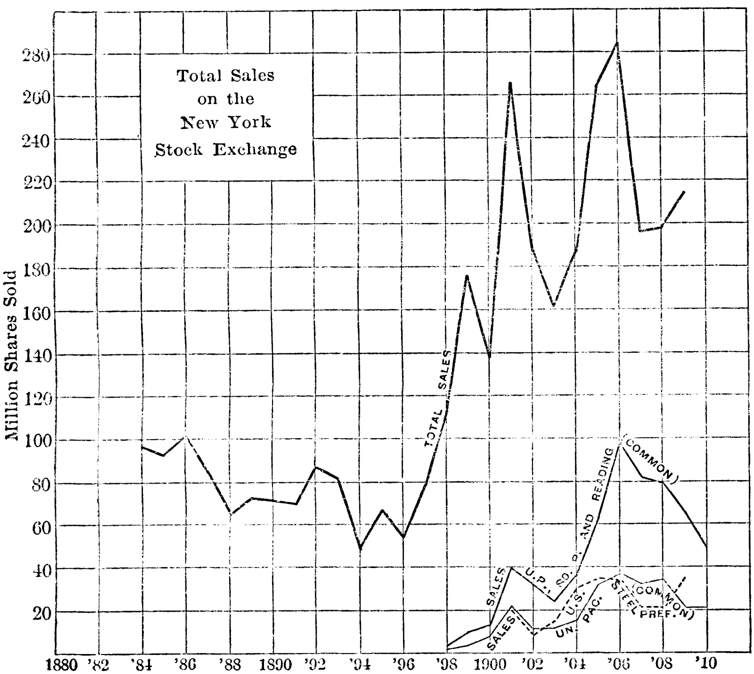
It is inevitable that in a relatively new and rapidly growing country, like the United States, speculation in railroads, as the chief agency in its industrial advancement, should be more common than in Europe. Risks must be run by hardy pioneers; and the rewards and losses attendant upon success or failure must be correspondingly large. Yet one might properly anticipate that with the passing of the pioneer stage a more settled order of business might ensue. It is a striking fact that this is not so. At no time in our history have stock-exchange operations in railroad shares been carried on both absolutely and relatively upon any such scale of magnitude as during

the decade to 1910. This is perhaps the more remarkable in view of the coincidently great development and activity of speculation in the shares of the great industrial combinations. Speculation has not been continuously rampant of course. Periods of intense dulness have often prevailed. But such wild outbreaks of general public interest as occurred in April, 1901, January, 1903, October-November, 1904, November-December, 1905, and August, 1906, are certainly unprecedented in our history. And that organized manipulation by powerful groups of railway capitalists has been a potent factor in this field is beyond dispute. Of course the kaleidoscopic changes of the railroad map due to rearrangement of the great transportation systems have centered much of this activity upon certain companies; but all alike have been affected to a certain degree. Happily there are indications that with the probable settlement of many of the larger problems in consolidation, and with the passing of some of the more daring leaders, this period may now be viewed retrospectively as more or less of a closed chapter in our economic history.

The course of speculation during the last quarter century is illustrated by the accompanying chart, showing the number of transactions annually upon the New York stock exchange. This diagram, like all others dealing with finance, portrays the extraordinary change in general conditions which has supervened since the panic period of 1893–97. A total of eighty to one hundred million sales annually before this period of depression now rises to nearly threefold that amount. Even the sharp depression of 1903 marks an aggregate of dealings twice as large as in the prosperous year preceding the panic of 1893.

And lest this speculative development be ascribed to the rise of the great industrial combinations during the last decade, supplementary curves relating to a few chosen railroads have been traced upon the same scale on the diagram. The lower one shows that annual sales of Union Pacific common stock alone for three years prior to 1908 amounted to



practically half the average yearly transactions of the New York exchange in every form of listed security, mining, industrial, or railroad, between 1884 and 1898. The middle curve is even more striking. It shows the dealings in common stocks of the three speculative leaders, Union and Southern Pacific and Reading. From practically nothing in 1898, all three

railroads having recently been reorganized, the transactions in these three stocks alone attained an aggregate in 1906 of nearly one hundred million shares. The total New York stock exchange dealings of every description prior to 1898 reached this figure but once before, and that was at the height of the extraordinary speculative excitement of 1886.

The rapid pace in speculation during the first decade of the century was set by the opening year, 1901. The events of that time are familiar: primarily trust promotion and widespread consolidation of railways, culminating in the Northern Pacific panic of the 9th of May. Dealings upon the New York stock exchange increased more than fivefold in that year as compared with 1896. Activity in standard companies like the New York Central and Illinois Central had begun as early as 1897.[1] By 1900 the second-class trunk lines like the Baltimore and Ohio had fallen into line. And in the following year, the movement extended to the transcontinental group, led, of course, by the Union Pacific. In this latter company, whereas for 1899 dealings did not average over 100,000 shares in a week, they culminated in the first week of May, 1901, in a total of 1,980,000 shares. This was a volume of transactions almost equal to twice the entire capital stock. On April 24, 1901, no less than 652,000 shares of Union Pacific changed hands in a single session of five hours. The classic Erie was entirely supplanted by the Harriman company. Such specialized activity fomented a speculative craze all along the line. The aggregate of dealings in particular companies during the calendar year is shown by the following table.

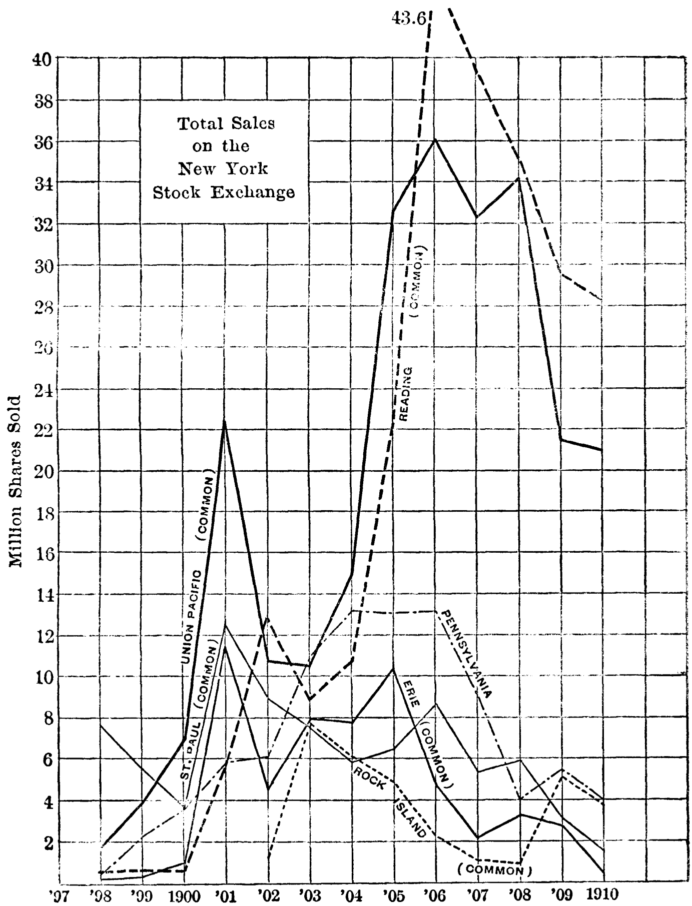
[1] The course of speculation in different companies is diagrammatically shown by weeks in U. S. Industrial Commission, vol. xiii, pp. 936–945.

	Shares		
	Sold	Outstanding	Times Sold
Atchison	12.100,000	1,020,000	12
St. Paul	12,500,000	558.000	22¾
Rock Island	8,100,000	600,000	13⅓
Erie	11,300,000	1,123,470	10
New York Central	2,800,000	1,150,000	2½
Northern Pacific	5,000,000	800,000	6¼
Pennsylvania	5,800,000	4,069,300	1⅓
Reading (common)	5,500,000	1,398,000	3½
Southern Pacific	11,300,000	1,978,000	5¾
Union Pacific	22,400,000	1,045,000	21¼
Wabash (pref.)	3,000,000	240,000	10½

Thus was the fashion set for "million share days." For the week before May 9th they averaged nearly twice that figure; and on April 30th, 3,200,000 shares changed hands in a single Stock Exchange session. Only once before, in December, 1886, had a million-share day occurred. High water mark seemed thus to have been reached. And yet the year 1906 carried the yearly total of transactions to an even higher point.

The march of events since 1898 for different classes of railroad securities is set forth upon a second diagram. Dealings in typical stocks are shown by separate curves. Most notable of course are the speculative leaders, Union Pacific and Reading common. The sharp contrast between the speculative "booms" of 1901 and 1906 is at once evident. Reading becomes the leader in the latter year; altho activity in Union Pacific common stock reached its climax, and held the center of the stage somewhat longer. More than forty-three million shares of Reading common stock changed hands in 1906; in other words, its common share capital was sold thirty-one times over within a twelvemonth. The "commodities clause" of the Hepburn Act offered the occasion; but the real cause lay in the absolute mystery which attaches

to every act of a company so financially involved in structure. An irresistible temptation to speculation is afforded both from within and without. Most of the other railroads, Erie, Rock Island, St. Paul,



and Atchison appear to have exhausted their energies in 1901, and responded but feebly in 1906 to renewed manipulation. Moreover some of these roads, notably the St. Paul and Atchison, evidently were passing

out of the erratic speculative stage and into the calmer zone of investment. The entire collapse of speculative interest in Rock Island and Erie at this time appears to be due to public appreciation of the permanent worthlessness of their common capital stocks as waterlogged concerns. The position of Pennsylvania shares is peculiar and puzzling. As a substantial investment company it would seem to have become involved in speculation largely because of the difficult financing of the New York terminal developments during this period. Yet there can be no doubt that all of the more conservative and reputable roads were more or less affected by the prevailing furor. Especially was this the case in trunk-line territory; where the problem of control of all the minor companies by the Pennsylvania and Vanderbilt interests was being worked out; and, of course, was of necessity being done in secret so far as the general public was concerned.

Various recent changes in fashion of investment have coincidently tended of late to promote greater activity in speculation in bonds. Foremost among these are the income bonds created during the reorganizations of 1896–97. Thus, during 1901 the Mexican Central first income 3s were handled more than twice over. The uncertainty, even at best, of forecasting the time when interest may be paid, with the added chance of changes of policy as to maintenance or of manipulation of accounts, as in the recent Central of Georgia case, renders such issues peculiarly liable to change.[1] The debenture bond, without its right of foreclosure, leaving it merely as a prior lien on earnings instead of assets, is a more sensitive creature than an old time bond. And most important of all,

[1] This case is discussed in detail by Dr. Dewing at p. 397 *infra*.

the widespread resort to convertible bonds of late years extends the natural susceptibility of stocks to changes of wind or weather into the domain of funded obligations. Such securities as the Baltimore and Ohio convertible 4s and especially the various Union Pacific convertible bond issues and the Oregon Short Line Participating 4s of 1904, all necessarily follow at a modest distance the fluctuations of the stocks upon whose welfare their own future depends. Such phases of recent financing have served to counteract the steadying influences upon bond values of the passing of even the memories of the great bankruptcies of 1893–97.

Single traders in a time like 1901, and to a considerable degree ever since, may deal in a hundred thousand shares in a day; and small pools may handle several times that amount. The number who, single handed, can operate to the extent of 15–25,000 shares in a day is said to be considerable. An episode of December 27, 1909, was illuminating, not only in regard to the volume but the technique of such speculation. The principal, a prominent officer of the Rock Island Company, distributed to each of twenty brokers an order to buy 2000 shares of his own road "at the market." Intending, of course, to distribute an equal number of identical orders to other brokers to buy, and thus to create an impression of great activity, covering up his own unbalanced dealings, he nevertheless for some reason failed to do so. The sudden unsatisfied demand for 40,000 shares rushed up the price by 31 points in five minutes and threw the entire exchange into an uproar. The motive in such "wash sales" was statistically shown in the evidence in the Montreal and Boston case in 1905. It appeared that the promoters

of this mining company had in one day bought 94,000 shares (mainly from themselves) for $271,000, and sold 87,000 shares (mainly to the public) for $275,000. An appearance of general interest in the stock was thus created; and on the basis of it the quotations were "washed" up from $1 to $2.50 per share. Meantime they were being quietly unloaded upon the public at the inflated price.

The notorious manipulation of quotations for Rock Island securities finds a counterpart in the recent pool operations in Reading stocks. The highly involved corporate organizations of this company, as has already been suggested, the facility with which its actual financial status may be concealed by expert accounting, the "commodities clause" of the Act of 1906, and the prolonged litigation over the standing of the anthracite coal combination under the Sherman Act, — all these factors have served to lend an air of portentous mystery to every movement of its shares. The rise in interest in it is manifested by the following table showing the number of transactions in Reading common by years.

Years	Shares sold	Years	Shares sold
1904	10,694,000	1908	35,165,000
1905	22,318,000	1909	29,342,000
1906	43,764,000	1910	28,196,000
1907	39,141,000		

The outstanding common shares numbering 1,400,000, it thus appears that its common capital stock, — residuary legatee of earnings after satisfaction of the fixed demands of its preferred shares, — was handled in 1904 seven and a half times over, in 1905 sixteen times over, and in 1906 thirty-one times over. The slightly flagging interest in it was revived again in the spring of 1909, when in three months its common capital was handled four times over. During the

third week in April, 1909, sales of its common stock equalled one half the total outstanding within five full working days. All this activity has naturally been accompanied by the widest and wildest ranges of quotation. From 1904 below $40 per share, to more than four times that figure in 1906, its erratic course has been a source of bewilderment to all observers. More than once the violence of its changes, as when in January, 1906, it was rushed up from $139 to $164, only to fall again within a month below its former level, and within a year to $70, has seriously menaced the general stability of the New York stock exchange. Plunging, attempted cornering, manipulation of the crassest order have been carried on by what appears to be one of the most powerful pools in existence.

The specific form of contract entered into by the participants in these pools has several times been made public as a result of subsequent investigation. In the Southern Pacific pool of 1902, to be described later, the gist of the compact was contained in the following paragraph:—

"Further we hereby authorize the said agent and manager to sell at his discretion the whole or any part of the certificates purchased, and in like manner to repurchase and again sell, so buying and selling at his discretion, provided, however, that the said certificates be not sold at a price that will subject us to any loss on the entire transaction." The agreement in the Hocking Coal pool, which, together with the one in Rock Island, collapsed in 1910, reads as follows:—

The undersigned, being desirous of purchasing at least 20,000 shares of the common stock of the Columbus and Hocking Coal and Iron Company, do hereby agree to purchase the same or so

much thereof as in the opinion of the hereafter appointed managers may be deemed advisable in the proportions set opposite the respective names of the said subscribers, and we hereby appoint ———, our agent and manager, to make such purchases at such time or times before the first day of September, 1909, unless sooner dissolved by the majority of the stock subscribed, in such manner and amount, and at such prices as in his judgment shall be to our mutual advantage.

Each one signing this agreement to pay on demand for so much of said purchases as his subscription (as near as may be practicable) bears to the whole amount subscribed, as such agent or manager may require. Also to return the same amount of certificates or part thereof at any time when called for at any time before the first day of September, 1909, on receiving from the manager the amount paid therefor, with interest at 5 per cent per annum. We further agree on any call from said manager to deliver to the said manager the same certificates theretofore delivered to us by him.

Further, we hereby authorize the said agent and manager to sell at his discretion the whole or any part of the certificates purchased and again buy, so buying and selling at his discretion. It is further agreed that any profits or losses incurred through the purchase and sale of said certificates shall be divided in proportion to the amount subscribed for by each one signing this agreement. No one signing this agreement shall have the right to call for a statement of accounts growing out of transactions herein authorized except on the request in writing of 60 per cent in amount of certificates subscribed.

Turning now to the consideration somewhat in detail of specific instances of speculation in railroad securities, they may perhaps best be grouped in two classes: speculation by "insiders" in shares of their own companies; and manipulation by "outsiders," either for its own sake or else with a view to wresting control from those who may be at the time in power. In both cases, the interests of the general body of shareholders are bound to be sacrificed for the benefit of a selected few. Of the two classes of speculative activity, the latter is probably less prejudicial in effect, inasmuch as the two

contending parties are more apt to be evenly balanced in resources. Sooner or later, moreover, the affair is bound to become public property. In such a struggle, the ordinary stockholder becomes merely a spectator, albeit a heavily interested one, unless it happens to come about that he holds the balance of power between the contending parties. In this contingency, of course, his position is a very strong one. But in those cases of speculation where the "insider" is pitted against the general public, including the great body of other shareholders, every advantage is upon the side of the privileged directorate or administration. All others are helpless, except in so far as the courts have been able to protect the rights of minority shareholders in cases of flagrant abuse of power.

One of the most serious of recent breaches of good faith between directors, their own shareholders, and the general public, in the interests of speculation was the manner in which in August, 1906, the Union Pacific dividend was advanced to its present high figure. This incident marked the culmination of the furious speculative campaign in the shares of this company which carried its common stock from a merely nominal figure in 1898 to nearly $200 per share in 1906. From this elevation it dropped to $100 in the following year. Not, however, the fact but the manner of increasing this dividend is subject to criticism. The Southern Pacific road was the largest single outside investment of the Union Pacific. It had been gradually fattened through many years by reinvestment of all its surplus in betterments. The harvest time had now come. Directors of both roads met in the same room at practically the same time. The Southern Pacific common stock was

placed upon a five per cent dividend basis. From this source and others, the Union Pacific company abruptly raised its rate from six to ten per cent, where it has since remained. The fact of this advance was rigidly concealed for two days, giving opportunity to those interested to reap large profits from the inevitable advance in price attendant upon publication of the fact. No official investigation has revealed the extent of these private operations. It appears to be well established, however, that aside from whatever interest the directors and their friends had in the stock market, a powerful "social pool" in the stock, which did not close out its holdings at the time, overstayed the market; and suffered heavy losses during the great decline of prices which soon took place.

The foregoing Union Pacific incident recalls a notorious episode in the early days of the New York Central road. On December 19, 1868, the directors, after a midnight meeting, announced an eighty per cent dividend in new stock and a four per cent cash dividend. The Financial Chronicle of that day thus comments upon the episode: —

> The real occasion of the dividend is to be found in the speculative operations of parties associated with the management. It is a matter well understood in the better informed circles of Wall Street, that, some few months ago, a knot of capitalists, mostly in the direction, combined for the purchase of $7,000,000 of the stock of the company; and in order to facilitate the purchase and the carrying of the stock, a loan was contracted with a London banking house upon the stock as collateral, the loan to run for two years, if necessary. The stock was systematically depressed previous to the purchase, and was bought at from 84 to 95, averaging about 90.
>
> The declaration of this dividend is the consummation of the scheme. The clique realize about 60 per cent profit on $7,000,000 of stock, or say $4,200,000, and a family prominently connected

with the road makes a still larger profit. But how has it fared with the ordinary stockholders ? At the time these gentlemen formed their magnificent scheme, the stockholders outside the "ring" were not only held in utter ignorance of the private plans of the directory, but the stock was systematically depreciated below its real value, so as to frighten them into selling to the directors and their friends.

This operation is a fair illustration of the manner in which directors speculate upon their exclusive knowledge of the affairs of corporations, to the injury of the non-official stockholders.

Still a third classic instance of the use of dividend increase, apparently to make a market for securities unloaded by "insiders," is the Atchison seven per cent dividend of 1887, increased from six per cent on the very verge of bankruptcy. No elaborate defences of this action have ever cleared the reputations of the guilty directors.[1]

Abrupt increases of dividend in connection with speculation for a rise by "insiders" are not the only means of surreptitiously taking advantage of foreknowledge of future events. Oftentimes the actual policy of the company in respect of surplus income devoted to betterments may be known only to a privileged few, the real condition of affairs being concealed by means of involved accounts. This it is which in part renders the stocks of non-dividend companies so susceptible to speculative manipulation. Of course the necessarily low quotations of non-dividend stocks offer an additional incentive; as a rise of a point or two in value of a stock which cost only $25 represents proportionately eight times as much profit as an equal rise of price of a share which cost $200. But it is unquestionably also the mystery attaching to a non-dividend security which is an aid to the professional manipulator. Chance

[1] Daggett, Railroad Reorganization, p. 198.

and change, — the daily bread of speculation, — have no concern with a security offering a rate of constant return. Speculation has promptly shifted from the preferred to the common shares of all such roads as the Reading and Atchison, just as soon as the preferred stocks began to pay regular dividends. The Lehigh Valley road, on the other hand, has of late been speculatively interesting largely because of its unrevealed potentialities. Between 1893 and 1904 the policy was rigidly pursued of suspending dividends, even on the preferred shares and of devoting every penny of income to development of the property; and yet, of course, no one outside of the management knew how extensive the betterment in reality was. The result has been an erratic career on the stock exchanges quite equal in range of prices to the wildest antics of Reading common shares. Within the year 1910, the quotations ran up to $242, down to $125, and up again to $175. This was associated with the Pearson-Farquhar plans, subsequently described, for an ocean-to-ocean line, which would have entailed extensive issues of new stock as well as greatly increased dividends. Meantime the general body of stockholders and the public remained in practical ignorance of the meaning of it all. The highly involved intercorporate accounts of the Rock Island Company, especially prior to their simplification in 1906, undoubtedly promoted its speculative activity for the same reason.

A merely negative policy of secrecy in administration only differs in degree from one of positive deception. Entirely fictitious statements as to earnings may be effectively utilized by "inside" speculators for a rise. Herein lies the possible advantage of even temporary control of a property, held, if necessary,

by means of operations on margin, instead of by actual ownership. Prior to the careful analyses of expense accounts, prescribed by the Interstate Commerce Commission, it was always possible to " skin " a road, that is to say, to postpone the customary and in the long run necessary outlay for maintenance. Savings thus effected could be utilized for enlarged dividend disbursements. On the strength of this showing, the speculators could dispose of their holdings at a profit, and leave the road practically gutted. In the old days a fictitious appearance of prosperity might easily be created by sending out orders to get traffic at any cost; thereby producing large gross revenues, and at the same time reducing maintenance expenses in the same proportion as the rates were cut. Net earnings would rise with the enlarged gross revenues, but the property, of course, would be steadily depreciating in condition. Such were the tactics charged against the old Atchison management in 1890, in order to enable the then embarrassed Barings to unload their heavy investment in the road. Such action they were compelled to take in an endeavor to avert a collapse of their South American enterprises. Such also was the program apparently threatened by the Gates syndicate in 1902, while temporarily in control of the Louisville and Nashville road. A general disturbance of the entire rate situation in the South promptly forced the bankers responsible for the Southern system and other roads in that territory to take over the property from the Gates syndicate at a large profit.

The series of events leading up to the collapse of both the Baltimore and Ohio, and Atchison roads in the nineties affords instructive examples of deliberate falsification of accounts by " insiders " in order to

create a market in which to unload upon the public.[1] In the case of the Atchison, income was apparently overstated during four years to 1893 by more than $7,000,000 in the aggregate. Of this sum nearly $4,000,000 consisted of rebate accounts, carried as an asset but having no value whatever. Ordinary expenditures were charged to capital account; uncollectible traffic balances were carried as assets; and arbitrary additions to earnings were made under orders from the East. Annual deficits, in one year no less than $3,000,000, were thus covered up; and an exhibit of steadily increasing earnings was publicly made. The revelations in 1896 in connection with the reorganization of the Baltimore and Ohio road were no less scandalous. During seven years and two months, dividends amounting to $6,269,000 had been declared, of which expert accountants averred that less than a million had really been earned. Net earnings had been systematically overstated, operating expenses had been charged to capital account as new construction; depreciation had been inadequately charged off by manipulation of profit and loss account; and, in the meantime, new capital had been issued to the amount of $50,000,000, and floating debt had risen from $3,500,000 to $16,000,000, without any corresponding new investment in the property.

The history of the Cincinnati, Hamilton, and Dayton road affords illuminating evidence of the disastrous effects upon a company of a series of speculative managements; managements, that is to say, chiefly interested in temporary control for purposes of speculation and sale to others, rather than of per-

[1] Details as to this are well marshalled in Daggett, Railroad Reorganization, Harvard Economic Studies, 1908, pp. 21 and 208.

manent development. Before it was first scuttled in 1886, it was conservatively financed, and was regularly paying dividends. Its shares were selling at or near par. At this time a New York banker named Ives purchased control by means of the well-known stock exchange devices of pyramiding.[1] Using each purchase of stock as collateral for loans with which to purchase more stocks, the price was run up to $150 per share, and by systematic manipulation was held near that figure. It is obvious that failure to support the price would lead to calls for more margin and thus bring about utter collapse of the artificial control. Branch roads were then purchased and heavy bond issues by them were floated by means of guarantees by the parent company. Ambitious projects for extension to St. Louis, as a formidable competitor of the Baltimore and Ohio, almost forced that company into its purchase, just as the West Shore road was unloaded upon the New York Central, and the Louisville and Nashville in 1902 was forced upon the Atlantic Coast Line. The scope and outcome of this Dayton project are best described in the annual report of the road for 1888.

At this date [June, 1886] the capital stock of your company was $3,500,000 common and $1,000,000 preferred. When Mr. Stayner and Mr. Ives resigned the presidency and vice-presidency respectively, August 9, 1887, the capital stock outstanding, as they stated it, had been increased to $4,000,000 common, and $11,000,000 preferred bearing 4 per cent.

The bonded debt of the company June 15, 1886, outstanding was $996,000 7 per cent, $1,434,000 6 per cent, and $400,000 5 per cent consolidated sinking fund bonds. This debt had been increased at August 9, 1887, by $64,000 consolidated sinking fund 5 per cent bonds and $2,000,000 second mortgage 4½ per cent fifty-year bonds.

To represent this enormous increase of liability and conversion and appropriation of securities owned by the company, amount-

[1] Bradstreets, vol. xv, p. 552, gives a good summary of these transactions.

ing in the aggregate to about $14,500,000 par value, your company, August 9, 1887, had betterments of its road, real estate, and additional equipment representing an expenditure of less than one million dollars. Your company had in addition credit on the books of Henry S. Ives & Co. for a deposit of upwards of $12,000-000, subject to check on demand, but when the firm of H. S. Ives & Co. made an assignment for the benefit of creditors, August 11, 1887, the assets of that firm included less than $1,000 in cash.

But the unhappy history of the Dayton road does not stop at this point. Its later manipulation has mainly had to do with repeated attempts to turn it over to some of the trunk lines, always, of course, at a profit. Within three years prior to 1905, the road has been passed in succession through the hands of no less than four syndicates. The first pool was originally formed in 1902 to purchase the Père Marquette road, running crosswise of the main trunk lines up into Michigan. The plan was by threat of extending it east and west to Buffalo and Chicago to force it upon the Vanderbilt roads at a profit. This project failed, leaving these capitalists with a heavy burden of unsalable and non-dividend paying securities. In the meantime another independent cross line, the Chicago, Cincinnati, and Louisville, had been constructed almost into Chicago by a second syndicate. A third pool already controlled the Dayton road. These three groups all overlapped in membership. All parties finally decided to join forces. The Père Marquette was sold to the Dayton road, by payment in Dayton bonds and notes at the rate of $125 for Marquette stock which had cost $85 per share. This recompensed the first syndicate liberally. The second syndicate which had built the line toward Chicago was paid for its services in Marquette notes. The third syndicate, controlling the Dayton road, now made its profit in turn by selling the combined

properties to a fourth syndicate in 1904. And it was this interest which so nearly succeeded in disposing of the road to the Erie at $160 per share in the following year. This was brought about by threats to turn the entire property over to the so-called Hawley interests, which were engaged at the time in piecing together various odds and ends in trunk-line territory. Fortunately the Erie management discovered the true state of affairs in time, and all arrangements for merger were abrogated.

Turning next to speculation by "outsiders," in order either to gain control of a company from others, or else merely to manipulate prices in their own interest, a typical example is afforded by the Keene Southern Pacific pool of 1902.[1] This episode is significant as showing the sort of attack which interests in control of a road must be at all times ready to repel, unless they actually control the property by ownership of a majority of the voting shares. The general situation must first be understood in order to comprehend the plan of campaign. The Union Pacific road, then in process of reconstruction, ended at Ogden, Utah. It was dependent for its through connection to San Francisco upon the Central Pacific road, which was a part of the Southern Pacific system. In order to acquire this necessary link in the transcontinental chain, the Union Pacific in 1901 purchased a practically controlling interest in the Southern Pacific, altho it was considerably short of a majority of the shares outstanding. But the major part of this extended system, reaching through Southern California to New Orleans, seemed at the time to be quite a distinct property, for transportation purposes,

[1] The following account is based upon litigation lasting throughout 1903, testimony in which was currently reported in the financial and railway journals.

from the small portion needed by the Union Pacific to complete its direct through line to the Golden Gate. The Union Pacific Company at once caused its recent acquisition to embark upon an extensive program of betterments. No dividends were paid by the Southern Pacific, in order that all net revenue (and there was a substantial amount of it) might be devoted to upbuilding the property. Nevertheless, just as in the case of the Lehigh Valley road, the actual extent of this rehabilitation and improvement remained for the general public largely a matter of conjecture.

The Keene pool, as appeared in the course of subsequent litigation, was dated January 29, 1902, and was to be continued until April 1, 1903. It was to become operative upon the purchase of 200,000 shares of Southern Pacific stock, which amount might be increased to 400,000 shares. As there were only 1,970,000 shares outstanding, and as the Union Pacific had only acquired 750,000 shares from the Huntington and other estates in 1901, such concentration of ownership in other hands was a matter of some importance. As a matter of fact, it appeared later that some 244,000 shares were actually acquired. The form of pooling contract adopted was much like that in the Hocking Valley Coal pool, as has already been shown. Having acquired this substantial proportion of the capital stock, the next step was to bring about a rise in its market quotations in order to unload upon the public. There is no evidence at all of an intention to continue the investment in the stock. Much of it in fact was not really owned, but was merely carried on margin. The plan was simple. The Southern Pacific Company was to be forced to modify its program of devoting

all net income to betterments; and was to be compelled to begin payment of dividends upon its capital stock. Such action would obviously serve the purpose. An elaborate campaign of publicity was then inaugurated. It was alleged that the Union Pacific was not really upbuilding the entire Southern Pacific road at all, but was merely "fattening" the Central Pacific link, in order at the proper time to cut it off and turn it over to the controlling company, thus completing the Union Pacific direct line to the coast. This in turn led to a spirited contest for control of the next annual meeting, recalling in many respects the struggle over the Illinois Central in 1907. Injunctions were sought to prevent the Union Pacific from voting on its 750,000 shares of Southern Pacific stock at the annual meeting on April 8, 1903, — only two days, by the way, prior to the original date of expiration of the pool. This action failed. In the meantime the Harriman party had succeeded in accumulating enough proxies from other stockholders to insure their control. Thus balked in its program, the pool was compelled to liquidate its holdings. This it did in the rapidly declining market of 1903, at very heavy loss. It was estimated at the time that the holdings which had cost about $16,700,000 were closed out at a loss to the pool members of approximately $3,000,000. Thus ended the chapter, about as disastrously as the Reading pool in 1906.

In form precisely like the Southern Pacific pool, altho differing in outcome, was the Gates raid upon the Louisville and Nashville road in April, 1903.[1] This road being about to issue $5,000,000 of new stock,

[1] This transaction was investigated upon complaint of the Kentucky Railroad Commission by the Interstate Commerce Commission in 1902–03. The complaint and answers are reprinted in the 23d Annual Report of the Railroad Commission of Kentucky.

it appeared likely that the market quotations would decline substantially by reason of the increased floating supply. Many traders in consequence sold the stock "short"; expecting to cover their contracts at the lower figure. The Gates pool quietly bought all the shares offered; thereby acquiring some 306,000 shares out of a total of 600,000 outstanding. With this clear majority, they forced the bankers in charge of the Southern road, which could ill afford any disturbance of the rate situation, to take it off their hands. The pool appears to have profited handsomely by the transaction, having acquired 102,000 shares for less than $110 per share and the balance at $125; and then having turned it over to J. P. Morgan and Company, at about $130 per share for the first lot, and $150 per share for the second. It was then placed in the hands of the Atlantic Coast Line Company "for safe keeping" at $160 per share. In much the same way and at about the same time, the Monon line from Louisville and Chicago was bought up by a speculative pool and finally turned over for joint control to the Southern and the Louisville and Nashville roads.[1] Such episodes as these are not only illuminating in themselves, but they serve to explain the extraordinary fervor of speculation which, as we have already seen, culminated at about this time.

The speculative acquisition of the Boston and Maine Railroad by President McLeod of the Reading road in 1892, however laudable the desired end in view for his company may have been, reveals the hazards of such modes of finance.[2] Early in that year, shares of the New York and New England and

[1] A. D. Noyes in the Forum, Oct. 1902, p. 204.

[2] U. S. Industrial Commission, ix, pp. 561–576, contains testimony on the subject. Daggett, Railroad Reorganization, pp. 123 *et seq.*, traces its effect upon the Reading Company. Bradstreets, vols. xx and xxi, contains many additional details.

Boston and Maine companies began to advance mysteriously, and in October virtual control of both by the Reading was expressed through the election of McLeod as president. The operation was difficult to understand, as the Reading had always been impecunious and was then in a peculiarly precarious condition. On February 20, 1893, it suddenly went into bankruptcy. The story is succinctly told in the report of the directors in the following January. In substance it was a case of speculation "on margin," and of the margin having been "wiped out."

> On the 25th day of October, 1892, President McLeod authorized the purchase of shares in the New York and New England Railroad Company, and ultimately 32,000 shares were acquired. President McLeod originally put up his own securities as collateral to protect the purchasing brokers. Subsequently, as collateral to secure these purchases, President McLeod, without having previously obtained the authority of the board of managers, drew from the treasury of the company and pledged the following securities [treasury securities enumerated].
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> The fact of the withdrawal and use of the securities was first formally brought to the attention of the board on December 14. On December 24 resolutions were passed ratifying the action of Mr. McLeod and indemnifying him for advances made on his individual account to the extent of $400,000. Messrs. F. H. Prince & Co. and Messrs. Ervin & Co. [the brokers through whom the purchases were made] subsequently gave notice of their intention to sell the shares for the purpose of reimbursing their advances, and ultimately, in pursuance of such notice, all of the shares were sold. After crediting the company with the net proceeds of sale, the total loss on the Boston and Maine Railroad stock was $918,008.09, and on the New York and New England stock $553,996.15, or a total of $1,472,004.24.

The most recent spectacular collapse of an ambitious attempt to create a transcontinental railway line on the basis of borrowed money occurred in July, 1910.[1] From some unrevealed source large blocks

[1] The financial journals of July 28, 1910, and the following week abound in descriptive matter.

of railroad stocks had been pressed for sale upon the exchanges for some weeks. It had been known since January that some mysterious pool had been quietly accumulating large holdings in various roads, especially of the Rock Island Company. The shares in other apparently unrelated properties, like the Lehigh Valley, had also been advancing sharply. The entire plan was disclosed when suddenly it was announced on July 28th that an English syndicate, heavily interested in a chain of roads from the Atlantic to the Pacific, had been forced by the steady decline in quotations to transfer all its holdings *en bloc* to a leading American banking house. The nucleus of the transcontinental system was to have been the Rock Island. It was to have been carried to the west by the Denver and Rio Grande, a supposedly Gould property, which in turn controlled the recently completed Western Pacific road to the coast. But in order to hold these, the Missouri Pacific had also to be included. Eastward, the line was to be made up of the Wabash and the Lehigh Valley roads to Atlantic tide water. No details have ever reached the public. But it was rumored that an investment of approximately $30,000,000 was finally liquidated for about half that sum. Had the affair not been terminated by private arrangement, in other words, had this huge volume of securities been openly forced upon an already over-loaded market, a disastrous panic might have been precipitated.

A common mode of protection against the raids of outside speculative cliques is the creation of a voting trust.[1] With a body of trustees, commonly five in number, all shares of capital stock are deposited, in exchange for so-called voting trust certificates. The

[1] Cf. Daggett, op. cit.; and the Yale Law Journal, vol. xiii, 1904.

important point, however, is that such exchange of securities is for a stated period of time; and vests all voting power on the stock in the hands of the trustees. This assures stability of control and continuity in policy. It has been a common feature of most of the great railroad reorganizations in recent years. Some voting trusts have been continued for many years, notably on the Ontario and Western road. When entered into for an indeterminate period, only terminable upon the declaration of dividends successively for a given time, it may operate disadvantageously to shareholders; but in the long run seems to be a convenient and necessary safeguard.

What remedies may be applied to check this speculative activity, in itself a menace to the safe and sane operation of the railroads of the United States? A powerful one has already been applied in the beneficent publicity features of the recent Hepburn Act of 1906, and as still further amended in 1910 in the Mann-Elkins law.[1] Little more in the way of specific legislation would seem to be needed; altho liberal appropriation for administrative oversight by means of expert accountants must of course be currently made by Congress. So far as checking speculation by "insiders" is concerned, the strict prescription by the Interstate Commerce Commission of the practice as to making depreciation charges would seem to be most effective. The matter technically bristles with accounting perplexities, and has been most bitterly opposed by leading railroad men. Some of this objection is more or less valid. Yet

[1] These provisions are described in the Quarterly Journal of Economics, vol. xxi, 1906, pp. 22–51, and vol. xxv, 1910, pp. 593–633. Accounting features are especially discussed ibid., vol. xxiii, 1908, pp. 364–383.

much unnecessary bitterness in discussion of the subject has been engendered by a misconception of the rules of the Commission. It is alleged that the insistence upon a clear differentiation between capital and income account in the matter of charging for depreciation or for betterment and new construction, will compel the companies to capitalize all betterment work instead of caring for it in part from surplus income by charging it to operating expenses. This by no means seems to follow. No actual policy as to the form of payment to be adopted in cases of improvement work is enforced by law. The only requisite is that, whatever the policy of the road may be, it shall be made evident in the published accounts for the benefit of all parties concerned. No one can question for a moment the expediency of oftentimes adjusting maintenance outlay in some measure to the exigencies of the moment; either by postponing it in part, or, if possible, by going to the other extreme and expending freely for maintenance in order to save in direct operating cost. Not even the excuse of artificially creating a favorable income return in order to successfully float new bonds or stocks is valid or admissible in the case of most companies in normal times. The accounts should reveal to all, and especially to public authority, the precise policy which is being pursued. Padded or starved income statements have in the past been one of the most prolific sources of profit to "insiders" in the case of speculatively managed roads. Most sound roads, of course, do not resort to such practices; but laws must be drawn to meet possible offences, even if they be exceptional. It is a matter for congratulation that such manipulation is becoming increasingly more difficult under the accounting supervision of the Interstate Commerce Commission.

Beneficent in its effects, also, will be all further careful regulation of intercorporate accounting. The consolidated balance sheet, as used by the Rock Island and Reading companies, is another fecund source of evil. The classic financial reorganization of the Alton road was so adroitly covered up in the accounts, that, as has been technically shown in the *Journal of Accountancy*, the holding company could pile up a surplus or incur a large deficit without danger of discovery. Not a trace of the very recently revealed and entirely unsuspected indebtedness of the Oregon Short Line to the Union Pacific Company, to the amount of $72,000,000, could be found in the reports of either company, until the directors chose to let it be known.[1] Such things should not be. Nothing so invites speculation as mystery. Whether the so-called "insiders" profit by it or not, is not the main question. Such secrecy certainly provokes speculative manipulation in others. So far as publicity can reasonably go, it should be applied with the utmost vigor.

Speculation thrives in the main upon securities of low market value. Such low quotations are usually the result of an over issue of securities; in other words of capitalization more or less in excess of either physical value or earning power. A second restraining influence upon speculation in future may therefore indirectly flow from enforced publicity, so far as it puts an end to the evil known as stockwatering.[2] This form of financial abuse is much less prevalent than formerly; it is in fact now non-existent probably in the case of most of our substantial roads. Yet in so far as publicity or physical valuation may serve to restrain the excessive output of securities by a

[1] New York Evening Post, Financial Supplement, Oct. 1, 1910.

[2] Discussed by the author in the Political Science Quarterly for March, 1910.

few erring companies, speculation may reasonably be expected to diminish as a consequence.

One of the most powerful checks may ultimately be found in some prohibition of excesses in inter-railway financing. Wholesale investment of corporate funds of one railroad in stocks of other railroads, especially upon a credit basis, has been a conspicuous and unwholesome feature of the last few years. The collateral trust bond has been a useful means of accomplishing this purpose. Of course as a means of building up a logically unified system, particularly in linking together naturally connecting roads into a through line, such intercorporate financing is necessary and proper. But when applied, as by the Union Pacific and the trunk-line roads, to control or investment in naturally competing or even entirely remote and disconnected properties, it may become a public menace. Particularly does it invite corporate speculation, that is to say, the purchase and sale of one road by another, not as an incident to operating efficiency, but merely for the sake of profit. It is not a wholesome condition of affairs that a railroad, chartered for the conduct of transportation, should be engaged in stock-exchange operations of this sort; and that a large part of its revenues should be derived either from such sources or from its investments in scattered and wholly unrelated roads. It is greatly to be hoped that the possibility of public interference to prevent such tendencies, even tho fraught with the danger of crippling suitable private initiative, may be rendered more remote by greater circumspection on the part of the directors of some of these great quasi-public companies.

Positive discouragement of undue speculation in railroad securities in future may possibly also be

looked for in the imposition by the states of taxes upon all stock-exchange transactions. A rich source of income exists therein; but the tax must, of course, be so applied as neither to hamper legitimate transactions nor to lead to escape by migration to other states. So far as it is practicable, a substantial tax upon all transfers of stock would seem to promote the general welfare, without unduly burdening the necessary processes of exchange. And, finally, a healthy public sentiment which shall frown upon manipulation of stocks for private profit, especially by those who occupy positions of trust, or which views large fortunes accumulated by such means as improperly acquired, cannot fail to exercise some influence. After all is said and done, the high regard of one's contemporaries is among the most coveted rewards of life. The country would seem to have passed through an extraordinary period of moral awakening of late. We may perhaps never again be called upon to witness such an orgy as this last decade has revealed. The outlook is far more satisfactory in this regard than it was five years ago.

The foregoing outline of speculative manipulation of railway securities tells but a sorry tale at best. It presents the most unpleasant aspect of railroad financing, embracing a range of operations from mystification and petty deceit to utter fraud. But the conclusion must be carefully avoided that, because such offences have at times been committed, American railroad finance on the whole is unsound. Such a conclusion would be absolutely unfounded. A large majority of our common carriers are certainly as honestly administered as are private businesses as a whole. Nor has the standard of integrity in the main ever been as high so it is at present. But, as

always, the innocent are condemned to suffer with the guilty. No single group of persons has a deeper interest in the prevention of such breaches of trust in future than that charged with the present management of this great industry.

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